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Secretary of the Commission  
Federal Communications Commission  
1919 M Street  
Washington, DC 20554

RE: Docket #MM 93-215

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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554

In the Matter of

Implementation of Sections of  
the Cable Television Consumer  
Protection and Competition Act  
of 1992

Rate Regulation

To: The Commission

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MM Docket 93-215

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PETITION FOR RECONSIDERATION

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Media Financial Analysts

Dated: October 4, 1993

## PETITION FOR RECONSIDERATION

Paul Kagan Associates, Inc. has been engaged in financial and economic research of the cable television and other media industries for more than 24 years. Its newsletters, conferences, reference books, fair market valuations and strategic consulting services have been employed not only by cable operators, but also by publishers, broadcasters, telephone companies, TV program networks, motion picture and TV program producers, computer companies, banks and investment banks, municipal, state and federal governments, professional sports teams, leagues and associations, and others with a deep and abiding interest in the provision of media to the consumer.

PKA is filing this Petition for Reconsideration at the request of the Commission because PKA has, over a period of more than 24 years, independently recorded and analyzed statistics and finances of the cable TV industry and published its findings for sale to both public and private interests. PKA feels strongly that the Cable Act of 1992 was not based on documented data developed either by Congress or the Commission and that enforcement of this legislation must be approached with the utmost restraint as long as the Commission lacks the knowledge it must have in order to justify the intentions of Congress. PKA believes that:

- 1) The data contained in this filing is the first of its kind that has been made available to the Commission

- 2) The data in this filing shows that the Cable Act of 1992 stands on shaky economic ground

- 3) Cable TV system rates are sensitive to at least 15 different variables, most of which are ignored in the regulatory process thus far

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4) Too much emphasis has been placed by the Cable Act on the cost per channel of programming as a key determinant of rate increases (although rising program costs cannot be ignored and should be accounted for)

5) Calculations of rate-of-return on investment, designed to serve as more accurate guidelines for rate regulation, cannot by any stretch of the imagination be restricted merely to original cost of equipment and exclude such vital ingredients of a cable investment as plant renewal, plant expansion and cost of franchises, customer lists and goodwill.

6) Cable TV systems are growth-oriented and highly sensitive to the high capital cost of technological change. They cannot properly be regulated as mature common carriers or monopolies lest they be rendered at competitive disadvantage to oncoming competition.

7) Cable TV systems cannot be regulated in the absence of a well-defined system of waivers and appeals that take into account system operating characteristics, individual corporate track records and the variables of differing financial structures. Such differences among systems and companies cannot in good conscience or fair practice be ignored in the regulatory process simply because Congress empowers an agency to regulate without adequate resources to analyze the differences.

PKA believes the Cable Television Consumer Protection and Competition Act of 1992 erroneously mandates the FCC to regulate cable rates in too broad a fashion, without regard to the differences among cable TV companies, where they are located, the exigencies of their individual operation and the way they are financed.

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To remedy the arbitrary nature of government-mandated rate benchmark levels, a Cost-of-Service Showing based on proper definitions is a fair alternative to the otherwise arbitrary edicts of the Cable Act. And the COSS process must be so well constructed and defined that it need not require excessive costs and consumption of time, neither of which are affordable for most cable TV operators or the Commission.

PKA will show herein that:

a) Cable TV rates are based on a multiplicity of variables, of which cost of programming is one

b) Cost-of-Service showings must embrace a review of multiple operating characteristics

c) There is ample data available on cable TV corporate financial structure to prove that rate-of-return analysis must account for intangible assets as well as original cost of equipment

d) Because cable TV operators must rejuvenate their physical plant assets frequently to remain economically competitive in the marketplace, benchmarks for rate regulation must not underestimate the operator's total Cost-of-Service

e) The relative low level of after-tax profits for dividends to shareholders and the historical absence of inside shareholder sales in the cable TV industry is evidence that cable operators have largely reinvested cash flow from operations back into the industry in order to create new programming to meet public demand and to maintain technological and program competitiveness. In other words, arbitrarily constructed rate regulations are woefully lacking in recognition of the considerable sums it takes to build and maintain cable TV systems.

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WHAT IS THE EFFECTIVE MONTHLY RATE CHARGED BY A CABLE SYSTEM  
AND WHAT COMPONENTS ARE IMPORTANT IN ITS DETERMINATION?

The effective monthly rate charged by a cable TV system is the sum total of the revenues collected for all programming and services from all subscribers. Thus, the financial structure of the system is built upon the cash flows derived from basic, expanded basic (or tier), premium (or pay TV), pay-per-view, home shopping, equipment rental and installations. Any regulation requiring the deletion of one or more of these sources of revenue would impact the financial condition of the operator unless an off-setting source of revenue could be found.

PKA has isolated 18 variables that have an impact on a cable TV system's financial structure, of which 15 also have an impact on the rates the system charges its customer. These are not necessarily all of the factors that determine price, but they sufficiently encompass the fundamentals of operating a system. Missing from the list is a consideration for management ability--an element beyond the limit of government regulation--and community image--one of the most visible factors in the government study of cable TV, but one that cannot be equated to financial structure because financial institutions lending to, or investing equity in, cable systems assume in each case a satisfactory community image going forward.

PKA does not suggest herein that the variables of system operation can be quantified into a shorthand formula. Thus, because of other variables extant in a particular situation, certain factors (like terrain or density) may be more or less important to a system's operating and financing potential. PKA does suggest, however, that in making a determination as to

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whether any one cable system makes excessive charges, the Commission is required to take into account the system's real-life parameters. To ignore the system's vital resources simply because the Commission does not have adequate resources of its own would be a disservice to the public interest the Commission is charged to protect. The 15 factors that impact on rates are:

Number of head-ends	Program configuration
Geographical terrain	Program costs
Population density	Local ad potential
Financial structure	Municipal costs
Local economics	Demographics
Equipment cost	Media competition
Plant condition	Area climate
Existing rates	

The Commission might say that such a list is too complex for a government agency to consider in establishing regulations, that some easy, one-size-fits-all formula is the only monitoring system it can afford. The only trouble with that approach is that the financial community studies the preceding list of factors in making a decision to lend funds to a cable operator or to buy equity in the operation. And it is the resultant financial structure (as noted above) that is one of the factors in determining rates.

Similarly, the factor of existing rates cannot be dispatched with the simple statement that they must be changed because they must be wrong. Rates and rate packages are different within systems for different groups of consumer users. It was not contemplated by Congress or the FCC to discriminate among users and yet that is what the arbitrary rules of the Cable Act require.

The Effective Monthly Rate of a cable system (EMR) is that rate paid by a consumer for the aggregate of services received. It is the rate that reflects a compromise between the cost constraints of the operator and his financiers and the budget restraints of the consumer end-users.

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According to data compiled exclusively by PKA, the average subscriber's EMR, in the six years beginning in 1987 after deregulation, rose at a compounded annual rate of 6.2% (Table 1). That was in excess of inflation, but in view of the presence in the package of totally discretionary spending like pay-per-view and home shopping, the somewhat higher number simply reflects the increased availability of services offered to the subscriber.

Minus the ancillary services, Rate-Based Revenue (RBR), i.e., average monthly rate charged only for basic, expanded basic and premium services, rose at a compounded annual rate of 5.7% from 1987 through 1992.

Let the record show that the genesis of the Cable Act revolved around only the rate charged by operators for Basic Cable, a rate that PKA estimates rose annually at an average 10.2% from 1987-92. As time, and the debate in Congress, went on, the Act came to embrace far more than just Basic Cable, even though no empirical data had been compiled by government officials on rates charged for supplementary services. Indeed, as the Act has come into effect it has been criticized for lowering the EMR of the industry's heavier-using (i.e., more affluent) subscribers. That has come as a surprise to both Congress and the Commission, even though PKA, and others in the industry, warned that it would happen.

The Cable Act of 1984 recognized that premium cable services such as Home Box Office and Showtime were, with their escalating rates, subsidizing those subscribers taking only Basic Cable. As a result of this anomaly, cable operators were incentivized to encourage the development of channels for extra charges and were not encouraged to create advertising-based channels for the Basic package. The Act of 1984 changed that, enabling operators

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to raise basic rates in keeping with the service provided. They flattened premium channel rates and poured their cash flow into creation and marketing of new Basic-only channels. Although the process necessarily began slowly, the industry developed at least seven new networks from 1987-1991, besides adding to channel lineups more of the existing networks as capacity became available. As the trend developed, operators also began to pay more per subscriber per month for basic network programming (Table 2).

In 1986, the total monthly price-per-sub charged by 20 basic cable networks was \$1.81, according to PKA data. (PKA is the only company in the U.S. that conducts this study.) In 1992, the corresponding figure was \$4.60, a 154% increase. Actual prices charged were lower because of negotiated rates, but the cable industry's smaller systems generally are unable to negotiate off the rate card. It's important to note that, because 20 networks were in the 1986 study, vs. 27 in 1992, the average rate per network was up "only" 89%, and not 154%. Still, the data shows that under deregulation, the cable industry dramatically expanded the programming available to Basic subscribers, whose rates properly reflected their new-found role as true subsidizers of the system's growth.

That the Cable Act of 1992 reached out to embrace Expanded Basic and Premium programming as well was a surprise to many, because government comments en route to the Act did not take into account the decrease in Premium subscribers and rates that impacted the cable TV business in the years between the two pieces of legislation. In fact, the average Premium service rate declined from \$10.31/mo. in 1986 to \$10.17 in 1992. And the average ratio of Premium subscribers to Basic subscribers fell from 82% in 1986 to

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74% in 1992. That lowered the effective rate charged Premium subscribers from \$8.45/mo. in 1986 to \$7.54 in 1992. PKA wrote about this subject extensively during the years of deliberations leading to the Act of 1992.

Table 1

EFFECTIVE BASIC MONTHLY RATE OF AN AVERAGE CABLE TV SYSTEM

	<u>1986</u>	<u>1992</u>	<u>% Avg. Change</u>
Basic cable.....	\$ 10.67	\$ 19.08	+10.2%
Premium cable.....	8.45	7.54	- 1.8
Expanded basic.....	.90	1.26	+11.5
Mini-pay.....	-	.09	n/r
Pay-per-view.....	.08	.66	n/r
Home shopping.....	.05	.14	n/r
Miscellaneous (*).....	1.01	1.56	+ 7.1
<u>Total</u>	<u>\$ 21.16</u>	<u>\$ 30.33</u>	<u>+ 6.2%</u>

*n/r denotes annual % change not relevant for this table*

*(\*) Miscellaneous category includes set-top converter rentals and additional outlets per home*

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Showing a system's revenue economics this way reveals a) a major flaw in the basic precept of the Cable Act and b) an obvious route to common sense regulation. First, the flaw:

A total of only 65 cents/mo., a mere 7% of the \$9.17/mo. average revenue-per-subscriber increase for the cable industry over a 6-year period, can be attributed to optional services taken by cable's heavier users (the consumer most able to pay and least in need of government rate regulation).

The revelation here is that, in terms of dependence for life support, the cable TV industry's vaunted new services in recent years--pay-per-view and home shopping--have not become major revenue generators. The only big gainers in the monthly revenue column have been Basic Cable (permitted by the 1984 Act), Expanded Basic and converters/remote controls/additional outlets. Had

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they been regulated earlier, consumers might have paid a bit less for overall cable service. But then, they wouldn't have received the added channels or the more convenient technology.

Since almost all of the average increase came from the Basic service (which Congress approved in the 1984 Act), the logical route to regulation would be to place a governor on the Basic rate, perhaps in holding it to a Consumer Price Index benchmark.

Although a 6.2% rate of growth exceeded the average rate of inflation during the period in question, it can be attributed to the increasing amount of service (number of channels of programming) offered by the operator. Under no circumstance did it justify the expenditure of millions of taxpayer dollars in the lengthy legislative deliberations, nor did it justify turning the Commission upside down in order to control it.

Still within the subject of a major flaw, the data as shown above indicates that in the midst of the legislative process, Congressional focus shifted from the fastest-rising component of revenue--the Basic rate--to the expanded tier and the remote control and additional outlet column, even though these were the realm of the more affluent (but also more vocal) subscribers. First Congress, and now the Commission, listened to the beat of a different drum, and wound up mired in attempted regulation of consumer taste and choice.

As for the obvious route to common sense due process, it is clear in this analysis that Congress in 1984 voted for price fairness to the Premium cable subscriber and shifted the burden of supporting the system to the

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greater number of subscribers (those taking Basic). It was not unfair to the Basic subscriber, if only because of the promise of more channel choice to go along with higher rates. Cable operators delivered on that promise.

In 1992, Congress went in the other direction, placing the burden of subsidizing the system once again on the Premium subscriber, by demanding more restricted Basic rates. It went further, however, in regulating the set-top equipment and additional outlets that are necessary for the marketing of the ancillary services now needed to promote growth in the cable industry.

In summary, it appears that the Commission (on instruction from the Congress) has made a simple task most difficult. Since almost all of the cable industry's average increase in rates has come at the Basic level, and has been somewhat offset by lower income from Premium service...since Premium and other services are optional and consumed by the more affluent as entertainment options...and since Congress wishes to place more of the burden for supporting the system on the ancillary service consumers, the Commission should require an inflationary limit on the Basic service, where applicable, and permit the full development of ancillary services, which are wholly dependent on consumer demand.

The Commission might properly say that, despite industry averages, certain systems are well above the average in what they charge and should be more heavily regulated. The problem with adhering to the averages is that, first, it means those under the average must be permitted to raise their rates (as has been done since the Commission's new benchmarks have gone into effect). It is one of the flaws of creating an arbitrary national average as a standard for regulation. PKA does it for financial analytical purposes, but it frequently provides a footnote that statistical averages are not to be ap-

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plied arbitrarily to any one system. Evaluation of any individual business requires a much more thorough examination of the variables impacting that system's operations (as mentioned earlier in this petition). In the instant case, government officials are attempting to do that which is not permitted in the field of sound business practice, i.e., use an industrywide average to make rules for all systems, regardless of the exigencies of operating any one business. Congress and the Commission are in the process of creating a furor at the municipal level because national or even regional standards for cable TV system pricing cannot be generically determined, given the many variables that have an impact on the pricing and value of a private enterprise.

In the foregoing analysis, PKA has used generic data to make a specific recommendation that would work and would save this deficit-ridden Federal government enormous amounts of precious money and time. If it is felt that annual rate increases in Basic cable are too great, then place a governor on them that will hold them to the pace of inflation. Any further regulation on ancillary services would overly restrict the cable industry at precisely the moment when it is trying to build the electronic superhighway the Federal government has called for in another proceeding.

**WHAT DO CABLE TV PROGRAMS COST AND SHOULD SUCH COSTS  
SERVE AS THE BASIS FOR REGULATING CABLE TV RATES?**

Somewhere in the 3-year legislative process, some importance was attached to the amount of money a cable operator pays a network for its programming. It is PKA's belief this philosophy was fostered by broadcast stations that became enamored of the license fee payments being earned by cable networks, in addition to their advertising revenues. Indeed, for more than a year, television stations have built up their hopes of generating from cable

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operators the 10 cents to 25 cents per subscriber revenues garnered by the cable networks. Hindsight now shows that most TV stations settled for carriage of their signals or indirect payments via carriage of new cable networks created by broadcasters. Cable operators were already faced with steadily rising program costs.

In an exclusive report based on 1992 numbers, PKA found that cable license fee payments to basic programmers exceeded \$3/sub/mo. at most systems and rose above \$4/sub/mo. for smaller operators. Adding in copyright fees for retransmission of broadcast signals and the total Basic program bill can eclipse \$5 at systems lacking the critical subscriber mass to negotiate volume discounts with program suppliers. Here are indicative numbers:

Table 2

<u>Basic program cost component</u>	<u>-----Cost/Sub/Mo.-----</u>	
	<u>Top 10 MSOs</u>	<u>Smaller MSOs</u>
Fees paid to:		
20 basic satellite services	\$2.50-\$3.00	\$3.00-\$3.40
1 regional sports service	.25- .65	.35- 1.00
2 superstation common carriers	.06- .12	.10- .18
Subtotal	\$2.81-\$3.77	\$3.45-\$4.58
Copyright fees *	.20- .60	.20- .60
Total	\$3.01-\$4.37	\$3.65-\$5.18

\* Estimates are based on standard copyright charges of 1%-3% of gross basic revenue, against assumed \$20/sub/mo. basic revenue.

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The data suggests that operators pay between 12 and 16 cents/sub/mo. per channel for basic satellite services and superstations only. Regional sports fees comprise the major variable in the basic program cost structure. A system paying \$3.25/sub/mo. for 22 basics/superstations raises its basic program bill a whopping 23% by adding one regional sports channel at 75 cents/sub/mo. Regional sports charges are driven primarily by market size. Even

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the largest MSOs pay the higher end of the scale for regional services located in top TV markets and carrying games of several professional sports teams.

Many operators see no relief on the horizon from double-digit annual percentage growth in basic program fees. Several have forecast 10%-20% hikes over each of the next 3-5 years, based on increases written into existing contracts. Basic program costs are not only the fastest-growing MSO expense-- they are also often the biggest, surpassing even payroll costs.

Obviously, a cable system's program costs vary depending on how many, and what type, networks it carries. A Kagan study of 14 publicly held cable operators, with over 27 million subscribers (half of the total cable universe) indicates total program expenditures of approximately \$1.07 bil. in 1992, equal to about 21% of the total expenses of the systems:

Table 3

14 PUBLIC CABLE GROUP OPERATORS  
(Estimates for 1992)

		<u>Per Sub</u>
Subscribers.....	27.2 mil.	
Revenue.....	\$9.62 bil.	\$29.47/mo.
Cash flow.....	\$4.43 bil.	\$13.57/mo.
Total expenses.....	\$5.20 bil.	\$15.93/mo.
Interest.....	\$1.88 bil.	\$ 5.76/mo.
Capital expenditures.....	\$1.51 bil.	\$55.51/yr.
Program expenditures.....	\$1.07 bil.	\$ 3.28/mo.
Taxes.....	\$ .27 bil.	
<u>Free cash flow.....</u>	<u>\$ .05 bil.</u>	

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In its quest for an easy formula, one of the handles the Commission found early in its analysis was a cost-per-channel yardstick. It is, at best, an attempt to find a zone of stability in a most volatile world. If a system's monthly rate can be divided by the number of channels it carries, perhaps then it can be compared with other systems. That is a theory built on quicksand. As previously noted, what if one channel costs 10 cents per

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sub per month and another one costs \$1? PKA does not recommend that the Commission investigate each system's negotiated program costs to determine if it has the same program channel anatomy as another system. The Federal government must strenuously avoid micromanagement of private industry, especially if the net effect of all its efforts is simply to move revenue from one column to another and perhaps save each consumer \$2/month. The cost of such a program is enormous. And in the end, the consumer pays a hidden tax in the cost of the regulation.

The main reason the Commission cannot use program cost as a useful benchmark for monthly rates is that it arbitrarily ignores 14 other components of the rate structure, as previously outlined in this petition. Program costs can only be viewed in relation to other costs, both real and implied.

As a result of this petition, the Commission possesses information on cable system program cost it did not have before. PKA urges the Commission to use the information for the purpose for which it was gathered: to better understand how systems and the industry operate, what makes them sound businesses and why they have been able to supply so much of what the public has demanded. Cable, after all, came into existence because the Federal government never licensed as many over-the-air TV channels as the public wanted.

New cable channels were created originally under Federal government mandate, in a successful attempt to provide the population with a diversity of voices. Given the capital expense required to consolidate and build the facilities needed to carry the programming, and the additional funds required to create the programming itself, the income statements and balance sheets of cable system operators are totally understandable.

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The most significant observation made in the foregoing comments is that cost-per-channel varies from network to network and from system to system. That's why it is not desirable to apply industry averages to actual system rate cards and operations.

Prior to the requirements of the Cable Act of 1992, a typical cable system may have raised its basic rate from \$16/month to \$18/month, while adding four new channels. On the surface, it appeared that the system unreasonably raised its rate 13%, far above that of inflation. In fact, it might have been forced by inflation to raise its rate 3%-5% even without adding any new channels. Thus the new channels, in this example, were accompanied by an 8%-10% increase in rate, or \$1.28-\$1.60 in higher charges. At an average cost-per-channel of 15 cents, however, the system's new profit would be only 68 cents-\$1.00. What's more, the contracts governing the new networks may have called for 15% annual price increases for three years (as noted in the foregoing comments). This might have added another 32 cents/mo. in annual cost to the operator before he could institute another rate increase. That would reduce his expected profit on the new rate to 36 cents-68 cents per subscriber per month. Yet, at the consumer level, it seemed like a wholly unreasonable \$2/mo. increase.

PKA believes the thrust of the move toward regulation of cable rates was motivated by activity as described in the foregoing, i.e., a misunderstanding of the economics of operating a cable TV system, and a lack of understanding of the incentives required for cable operators to develop new programming. By using a cost-per-channel yardstick and applying broad-brush averages to individual cable systems, the Commission has effectively incentivized the operator to develop new channels as pay TV options. The system created by the Cable Act of 1984 was better for the consumer.

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WHAT IS AN OPERATOR'S TRUE COST-OF-SERVICE,  
HOW CAN IT BE ANALYZED, AND  
HOW CAN IT BE USED TO REGULATE THE INDUSTRY?

Given the heavy use of averages and general yardsticks in the Commission's regulations thus far, the importance of the Cost-of-Service Showing has risen dramatically since the new rules were first published. The Commission has warned that the task of reviewing each system's appeal is so monumental that it threatens to levy harsh judgments on those operators that avail themselves of the process of appeal outlined in the Act. PKA urges the Commission to reconsider its stance and not force the thousands of cable operators to herd into artificial, generic groups for the sake of regulatory convenience. Methodology can be developed to permit operators to show why they are differentiated and why they deserve at least a proper hearing if not an amended rate structure.

The Commission could break new bureaucratic ground with a short-form questionnaire that allows it to identify systems by type, by terrain, by population density, etc. Initially, this would enable the Commission to understand the basic, fundamental reasons why a system charges the rate that it does. Considering the weight of the Commission's responsibility in the months and years to come, it must not refuse to possess such information.

A cable system's Cost-of-Service cannot simply be coded as that cost incurred to acquire the original transmission facilities. It is easy to say it, but it is a meaningless number. Supreme Court decisions that permit cable companies to write off customer lists and franchises against their tax liabilities serve as proof that most of a system's acquisition cost is a tangible asset. In addition, an operator's investment hardly ends when he takes over the system. With average capital expenditure of \$55/year per

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subscriber (in the 14-company PKA study previously mentioned), an operator who buys a subscriber for \$2,000 will have a \$2,550 cost after 10 years, not including operating losses from investment in marketing new services.

This is an industry that produces marginal profits, but which faces possible rate-of-return regulation. It is a spurious theory.

There has been some discussion in government circles that cable operators paid too much for their businesses during the heady financial days of the 1980s. That is not the case, but what is more important, the Commission as a government agency must not sit in judgment of the value of corporate enterprise, especially posthumously. Values are created by market supply and demand, and the ability and the desire of the financial community to fund the demand. In the 1980s, when values in general peaked for most businesses, there was an overabundance of capital on hand to enable buyers to encourage owners to give up their rights to cash flow.

That the buyers of the '80s did not overpay for their acquisitions can be seen in the following facts:

- No major cable company (the largest borrowers) suffered a financial failure in the wake of the 1990 credit crunch
- The high-yield bonds of all major cable companies recovered in a spectacular manner from the junk bond crash of 1990
- The public bond market considers cable securities among the most attractive to be bought. Exclusive PKA data show that in the year ended 6/93, public bond investors loaned \$4 billion to the cable TV industry.

When PKA began analyzing cable TV industry finances nearly 25 years ago, it was challenged by numerous financial experts to explain how operators

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could survive the incessant rebuilding required by the technology. It responded with two-and-one-half decades of data showing no end in sight to the public's penchant to consume television, cable's highly predictable cash flow and its superior understanding of what the public desires in TV and technology.

A typical operator's Cost-of-Service appeal will show that he does not earn an adequate return on capital in comparison with any other media company, but that he perseveres because he is certain enough of his future cash flow to proceed with expansion. More than most other types of enterprises, the cable system requires huge amounts of capital for acquisition and operation. It can obtain the financing, however, because lenders receive senior claims on its cash flow. It is important to note here that at the current time, life-blood capital is being denied to a significant portion of the nation's cable systems because of the passage of the Cable Act and some of the Commission's regulations. The Act has wrought particular hardship for the industry's smaller systems because already heavily regulated banks have shied away from the notion of similar government intrusion into the cable sector.

Table 5

COMPONENTS OF THE PURCHASE PRICE  
OF A CABLE TV SYSTEM

Subscribers.....	5,000
@ \$2,000 each.....	\$ 10,000,000
Cash flow.....	\$ 1,000,000
Cash flow multiple.....	10x
Existing subs @ 7x CF.....	\$ 7,000,000
Future growth @ 3x CF.....	\$ 3,000,000
Add-on capital @ \$500/sub..	\$ 2,500,000

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Viewed in the light of Table 5, the investment in a cable system never ends. Add-on capital (gradual rebuild over a 10-12 year period) used to be \$100/sub. That was when you could buy a sub for \$500. But that was when

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cash flow was \$250,000 mil., not \$1 mil. Indeed, new digital and switching technology is in the process of raising the cost of rebuild by 50%. Thus, Time Warner has announced a plan to spend \$5 bil. on rebuild of its 6.5 mil. subscribers over the next five years. That works out to \$769 per sub. Correspondingly, a typical cable/telephony sub in the United Kingdom costs about \$1,500 to build from scratch.

The Commission's Cost-of-Service questionnaire must contain a space for the type of equipment a cable operator owns and the type he plans to put in as he rebuilds going forward. Any discussion of cable rates must be predicated in part on the level of sophistication the operator plans. No discussion must be based on the assumption that any two systems have similar facilities, unless the facts are known.

The Commission's own rules give municipalities the right to impose varying levels of local regulation on cable systems. The Commission must not blink away the differences that will arise between systems that have more or less intense municipal oversight. Government cannot have it both ways: It cannot impose rules that cause differentiation at the same time it imposes rules that insist on homogeneity.

It is PKA's belief that system characteristics are identifiable and quantifiable. While they do not easily lend themselves to a shortcut formula for subjective analytics, they nevertheless can be branded, sorted and rated. But only in the process of their being heard.

In terms of hard numbers, if a cable operator posts \$1,000 of his own capital and borrows another \$1,000 to buy a subscriber, and if he then invests another \$500-\$750 over time to improve and expand his system, he must be allowed to earn a rate of return on his entire capital investment. If not,

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he will be discouraged from making the investment and the government will have defeated its very purpose--to bring the public a diversity of well-financed and well-operated media voices.

Already, the rules promulgated by the Commission under the Cable Act of 1992 have choked off financing to smaller systems unable to keep pace on the technological front. Restrictions in how much systems can charge for programs offered have reduced or slowed the growth of cash flow which is, in turn, the basis used by lenders to provide financing.

According to exclusive PKA data, there were fewer systems sold in the first seven months of 1993 than in any other year in the past decade except 1991, when the bank credit crunch was at its worst. The month of July, 1993 witnessed the first that PKA had ever recorded in which no systems were sold at all. In 1989, the average cable TV system was sold for \$2,303 per subscriber. In 1992, the average system was sold for \$1,763 per sub.

Because of the imposition of the new regulations, smaller cable systems have suffered an aftershock of the credit crunch. Although the banking system has tremendously strengthened its own books and now earns record profits, it has not lifted the embargo on credit for smaller systems because the Commission's new rules weaken cable cash flow and bring system operating ratios back below the more stringent covenants and ratios instituted by lenders during the crunch years of 1990-91.

PKA recommends that Cost-of-Service Showings include explicit data, easily obtainable from appealing applicants, that outline the artificial restraints placed on otherwise sound cable businesses by two institutions--financial and regulatory. Interest and amortization payments, cash flow coverage of such payments and capital expenditure schedules are among the

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items worth noting in this category. PKA also urges the Commission to engage in discussions with regulators in the Office of the Comptroller of the Currency and the Federal Reserve to gain a better understanding of the restrictions already governing cable operators because of another Federal regulatory body.

HOW ARE CABLE SYSTEMS FINANCIALLY STRUCTURED,  
AND HOW DOES THAT DETERMINE HOW THEY SHOULD BE REGULATED?

As in all the other categories heretofore discussed, cable systems are financially structured in a variety of ways. Thus it is difficult to apply the same regulations to all companies. Governing practices that can be applied uniformly to public utilities do not work for cable because they are entrepreneurial entities engaged in heavy marketing competition with other consumer entertainment options such as video stores, live concerts, movie theaters, stadium sporting events, home audio systems, etc.

Some cable systems have no debt on their balance sheets, but that is unusual. Most have built or acquired their properties through the use of debt leverage, at ratios of debt-to-equity ranging from 6-7:1 down to 1:1 or slightly less. Within the leverage category, systems are subject to a multitude of loan covenants that vary widely by system size, geography, technical and management characteristics. It is not possible, for the purposes of some uniform system of regulation, to know an average system's interest rate on debt, its debt payback schedule or the level of cash flow it must maintain in order to remain in conformance with its loan covenants.

The largest cable systems have the best access to the capital markets. They borrow at favorable interest rates and now operate at comfortable margins

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of debt-to-cash flow (for example, 2:1 or 4:1 rather than the more leveraged 6:1). As recently as 1990-91, however, even very large cable MSOs were in danger of falling out of compliance with loan covenants because of the ravages of the bank credit crunch. Only through the coincidental boom in low interest rates of 1992-93 and the consequent flood of public money into bond funds have the major cable MSOs been able to restructure their balance sheets and prepare for the capital intensive years of new technology that lie ahead.

Would that smaller systems were as fortunate. There could not have been a worse occurrence for smaller cable systems than the back-to-back events of bank credit crunch and Cable Act of 1992.

In implementing the Cable Act, the Commission should take into account the events of the years preceding the Act's passage. It should become aware of financial market conditions that placed systems in precarious positions despite otherwise satisfactory operating track records. Before the Commission can determine whether a system's charges to consumers are proper, it must first learn the financial parameters under which the system operates. It must ask the question, which regulatory agency takes precedence, communications or banking? It must ask the question, will an industry average benchmark that may or may not apply to any specific system cause the business being regulated to be subject to a foreclosure by its lender? It must ask the question, how can a business whose assets are pledged to a senior lender, and whose equity value is in question, become subject to rate regulation?

It is not the Commission's duty to ensure a good business for each operator. But neither should the Commission, on its watch, turn an otherwise sound operating business into one whose fiscal worth is in question. And yet, that is one of the consequences of a regulatory scheme that makes no distinction between companies with differing financial structures.

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PKA is the only source in the United States for estimates of public and private loans to the cable TV industry, data it first published in 1982. Its records show that cable TV systems are heavy users of leverage to acquire, build and maintain their assets. Because of the frequent need to rebuild and the escalating cost of programming and other operating costs, they require leverage to attract most equity owners who, in turn, pledge their cash flow to senior and subordinated lenders. Here is a profile of the industry's debt:

SUMMARY OF PUBLIC & PRIVATE LOANS TO THE CABLE INDUSTRY

	<u>June 1992</u> (mil.)	<u>June 1993</u> (mil.)
Banks	\$23,199	\$23,735
Insurance Co.	6,272	5,711
Finance Co.	3,663	2,675
Other	161	91
Public bonds	<u>7,938</u>	<u>11,910</u>
Total	\$41,233	\$44,123

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Note the drop in insurance company and finance company debt in the latest year recorded, and the general flattening of bank debt, which had been rising at 15%-20% annual rates in the 1980s. Most of the bank debt shown is concentrated in the 20 largest MSOs but most smaller systems have bank debt of their own, albeit in far less absolute amounts relative to the industry total. Little, if any, public bond money is available below the top ranks of cable groups.

Cable operators tend to borrow for 7-to-10 year periods, although virtually every 8-10-year bank loan is required, as a matter of practice, to be refinanced in 5-7 years. In the wake of the credit crunch, few 10-year

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